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northwest economic
indicators

NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Economic Dominance

February 21, 1980

Highlights

- **Compared to almost every other industrialized free-world country, the United States is much less dependent on exports for its economic health. In 1977, exports were only 8.3% of our gross national product as opposed to 29.5% for the United Kingdom.**
- **In addition, the large size of the U.S. market combined with the high export dependency of our trade partners means that these other countries are far more affected by economic conditions here than vice versa. For instance, in 1977 our purchases from Canada equalled 17.6% of that country's total output.**
- **Our trading partners' high dependence on foreign markets in general and the U.S. market in particular also means that changes in relative currency values have a far greater impact on economic activity in other countries than in the U.S.**
- **The volatility of the world economic and political climate in the recent past has led more and more to the use of fiscal and monetary policies by foreign governments to moderate the effects of external events on their own economies. This has meant a necessarily reduced role for these policies in controlling domestic economic forces and has been a source of friction between us and our allies.**
- **There is relatively little more these countries can do to control their economic destinies. The main responsibility for a return to a more economically stable world lies with the United States.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

"When the United States sneezes, the rest of the world catches cold." This analogy has often been used to illustrate the powerful effect that the relative health of our economy has on the economic well-being of our trading partners.

In nearly every introductory course in economics, the instructor has chosen to analyze the United States economy as a "closed" economic unit, i.e., a unit in which all economic activity is conducted within its own borders. In other words, any effect on our economy arising through the mechanism of international trade is excluded.

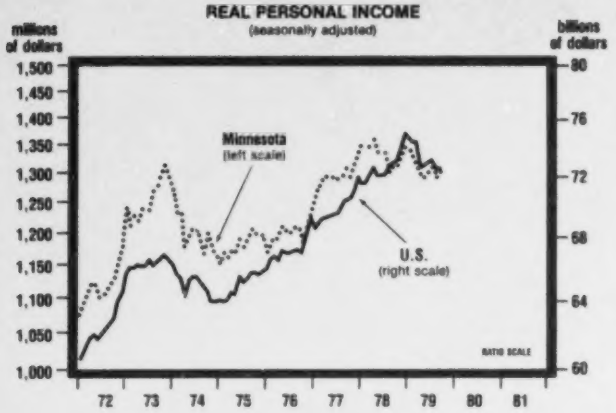
As a device for teaching the basic elements of economics as they pertain to the United States, this exclusion is reasonably justified. The overwhelming wealth of resources of nearly every possible type which lie within our borders does indeed enable us to satisfy the vast majority of our material needs without relying on goods and services produced in other countries. Indeed, if for some reason all international trade should suddenly stop, we as a nation would find adjustments far, far less disconcerting than any of our trade partners.

This certainly is not to say that we don't benefit from trade in the United States--we certainly do! From a comfort and convenience point of view, our lives would be far less pleasant without our Sony televisions and Nikon cameras from Japan or our Volkswagens and Mercedes Benzes from Germany. And, how many of us would like to start the day without a cup of coffee or tea? Moreover, we are all experiencing the definitely uncomfortable effects of uncertainty concerning the future availability and price of imported oil.

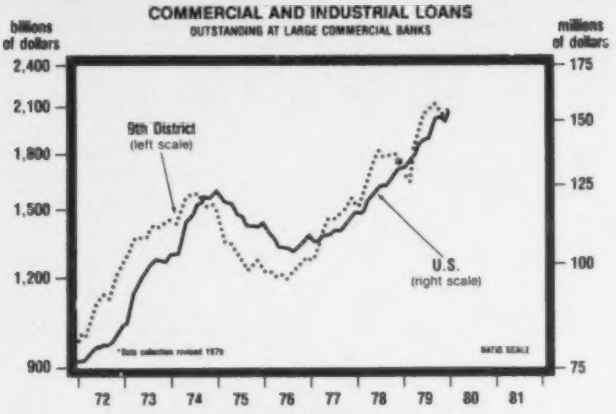
On the selling or exporting side, the recent embargo on trade with the Soviet Union has generated butterflies in the stomachs of many U.S. producers and particularly many of the farmers and agribusiness company managers in our own region. But, the fact remains that these problems are temporary. The grain not sold to the Soviet Union will eventually go to other users. Any lack of imported automobiles, television sets, and cameras would lead, in the U.S., merely to increased production of those goods by our manufacturers, albeit at the expense of the production of other goods which, under the circumstances, U.S. consumers would find relatively less desirable. Also, many goods would be higher priced than they are now.

REGIONAL ECONOMIC CONDITIONS

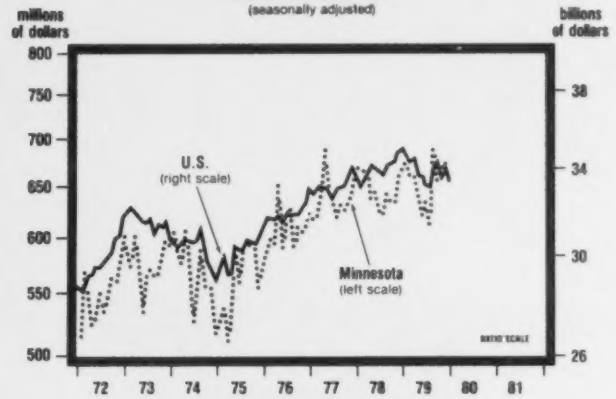
REAL PERSONAL INCOME
(seasonally adjusted)



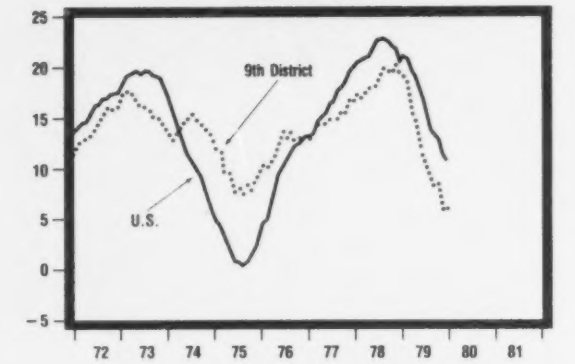
COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS



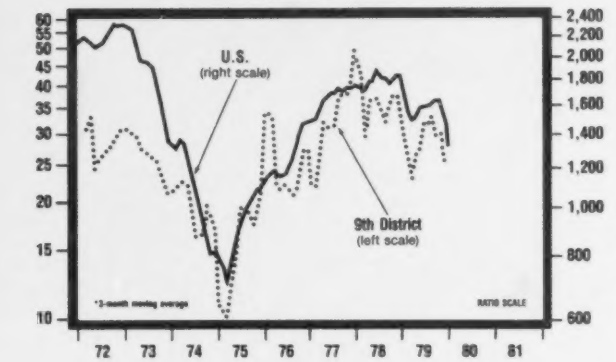
REAL RETAIL SALES
(seasonally adjusted)



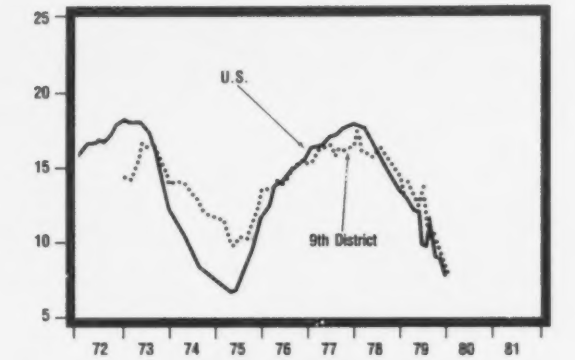
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



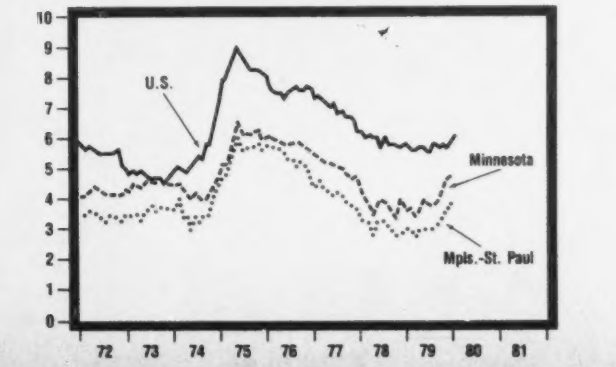
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



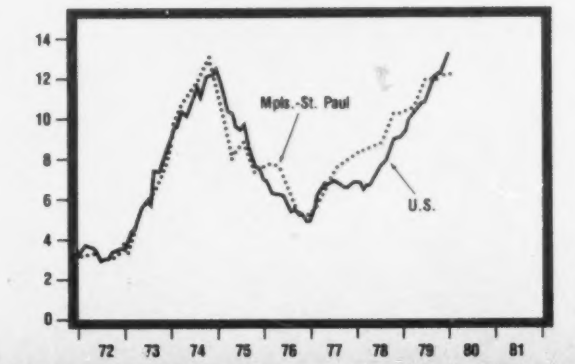
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



The Power

Certainly the United States is fortunate in its high degree of ability to satisfy its own economic demands. But now let's put things in perspective and take a look at how important international trade is to the other major free world industrialized countries.

Table I shows the substantial dependence most other industrialized countries have on foreign countries as generators of their own economic activity. While United States exports as a percent of our gross national product have shown some increase over the last decade, in 1977 we relied on foreign buyers in total to purchase only 8.3% of our output of goods and services. The United Kingdom, on the other hand, sold 29.5% of its output outside its boundaries, while Canada, France, Germany and Italy each had exports equalling 20% to 30% of their gross national product. Only Japan, with an 11.7% exports-to-GNP ratio, now experiences an export independency similar to that of the United States. This is likely to come as a surprise to many due to the high visibility of Japanese-produced consumer goods in our own society.

A major factor affecting the dependency on export markets by any country is the size of its own domestic market. Given the fact that development levels and real living standards do not vary greatly between the countries in Table I, the size of a domestic market may be measured in terms of population. As is shown in the table, no country except Japan has a population (and, therefore, an approximate domestic market) larger than 28% of that of the United States. The large size of the domestic market in the United States and, to a lesser extent, in Japan is a key factor in reducing these countries' dependence on foreign trade. Canada and the major European countries, on the other hand, are forced to sell a substantial portion of their output outside their own domestic markets in order to achieve the economies of scale associated with modern manufacturing technology.

Now that we have seen the heavy extent to which most other industrial countries rely on exports for their economic well-being, let's compare the relative importance of the U.S. market to other countries with the importance of their markets, individually and collectively, to us.

Table II illustrates that, with the exception of Canada, no other major industrial country represents more than seven-tenths of one percent of our total market. Again, excluding Canada the combined portion of our total output in 1977 exported to France, Germany, Italy, Japan and the United Kingdom represented only 1.9% of our production of goods and services. Canada, due to its unique economic ties with the United States, bought 1.8% of our output, or nearly the same amount as the non-North American countries listed above combined. In both absolute and relative terms, demand for the output of goods and services produced in the United States remains very insulated from aggregate demand conditions existing in any single non-U.S. country.

Consider, on the other hand, the importance of the conditions in the United States market to each of the other countries listed. Canada, again due in part to its unique economic closeness with the United States, relied on us to absorb 17.6% of its total output in 1977 while each of the other countries sold anywhere from 1% to nearly 3% of their total output to the United States. Considered in another way, the health of the U.S. economy in 1977 was anywhere from 4.1 times (Japan) to 8.0 times (Italy) as important to the listed non-North American countries as the health of each of their own economies was to us. In the case of Canada, this relative importance factor increased to nearly 10 times.

Moreover, these direct impact figures actually understate to some extent the dependence of the European economies on the United States. Since a very heavy proportion of each of these countries' exports go to each other,

Table I
EXPORT IMPORTANCE, 1977
(billions of U.S. $)

	Gross Nat'l Product	Total Exports	Exports as % of GNP	Population (millions)
Canada	$ 194.3	$ 50.8	26.1%	23.5
France	510.8	101.7	19.9%	53.5
Germany	704.3	190.7	27.1%	61.3
Italy	265.9	65.3	24.6%	56.7
Japan	1,060.1	123.9	11.7%	114.9
United Kingdom	328.5	97.0	29.5%	55.8
United States	2,127.6	175.8	8.3%	218.5

Source: International Monetary Fund, *International Financial Statistics*

Table II
Relative Market Dependency, 1977

	Exports to U.S. as a % of Total Exports	Exports to U.S. as a % of GNP	Imports from U.S. as a % of Total U.S. Exports	Imports from U.S. as a % of U.S. GNP
Canada	67.5	17.6	21.4	1.8
France	5.0	1.0	2.9	0.2
Germany	6.1	1.7	5.0	0.4
Italy	6.7	1.6	2.3	0.2
Japan	24.7	2.9	8.8	0.7
United Kingdom	9.3	2.7	4.5	0.4

Source: International Monetary Fund, *International Financial Statistics* and *Direction of Trade*

anything which has an adverse impact on their own economies will have an adverse impact on other members of the European Economic Community in a proportion approximately equal to their relative market dependence on each other. For example, an economic downturn in the United States would lead not only to a direct reduction in France's exports to us as a result of our direct trade linkage, but also to a reduction in French exports to Germany as a result of weakened demand in that country caused by a reduction in its exports to the United States. The greater relative dependence of each of the European countries on exports in total results in a magnification of both the direct and indirect effects of a change in economic activity in the United States.

The Problems

So what does this all mean? Is the economic health of our trading partners totally dependent upon the wellbeing of our economy? Certainly, this case cannot be argued very strongly. The two devils of inflation and economic stagnation can and are caused by factors indigenous to these countries as well as those outside its scope of immediate control. A desire for increased liquidity on the part of French consumers can lead to decreased consumption expenditures and, consequently, a weakened economy in France as well as in the United States. Pressure for wage increases unaccompanied by corresponding productivity increases on the part of British workers has been a primary cause of that country's high and persistent rate of inflation. No, these countries are perfectly capable, in theory, of exercising the greatest degree of control over their economic fortunes, whether they desire to do so or not. However, given their relatively greater degree of dependence on us than vice versa, distortions in their economies caused by fluctuations in our own economy will require disproportionately large corrective monetary and fiscal policy adjustments on the part of their governments.

Economic management was difficult enough for them under the system of fixed exchange rates which existed from the end of World War II to the early part of the 1970's. During this period, any economic stagnation in the United States tended to depress our real demand for imports which, in turn, led to a direct transmission of our cyclical economic difficulties to Canada, Europe and Japan. Offsetting this impact, however, were the much faster rates of productivity growth overseas, particularly in Europe and Japan in the postwar period compared to the United States, which led to dollar price increases for imported goods far below price increases for comparable U.S.-produced goods. This price advantage tended to support our demand for imported goods even during periods of U.S. economic decline, although this occurred at the expense of a serious deterioration in our balance-of-payments position, particularly during the 1960's.

By 1971, the chronic balance-of-payments deficits on the part of the United States had led to a supply of dollars held outside the United States sufficiently large to be deemed an undesirable surplus and, consequently, the fixed exchange rate system was abandoned.The ensuing period of flexible exchange rates, however, has created new problems for our trading partners and, in many ways, has increased their susceptibility to changes in our own economic climate.

A primary role of flexible exchange rates is to adjust for intercountry price differentials arising as a result of differing rates of inflation. For example, suppose identical automobiles are manufactured in two countries, A and B. At the beginning of 1979, these cars sold for 2,000 pesos (A's currency) in A and 1,000 francs (B's currency) in B, resulting in an exchange rate of 2 pesos for 1 franc. Now, in 1979, inflation in A brings the price of a car there to 4,000 pesos, but stable prices in B result in cars there remaining at a price of 1,000 francs apiece. Fixed exchange rates would result in A's citizens buying all their autos from B, since these identical imported autos, at 2,000 pesos apiece, would now cost only half as much as those produced domestically in A. The result would be a balance-of-trade surplus for B and a deficit for A. If, however, exchange rates were free to adjust, the increased demand for francs by A's citizens to pay for their imported cars would lead to an eventual increase in the franc's price to 4 pesos apiece. At that time, an automobile would cost 4,000 pesos in A whether it was produced there or imported and each country's trade position would again be balanced. Moreover, the real price of autos in each country--one for one since they are identical -- would again be reflected by their respective money prices.

What a pleasant world it could be if everything worked as smoothly as this simple example indicates it should. There is, however, a Mr. Hyde for every Dr. Jekyll and here international economics provides no exception.

Consider the present oil situation. The oil exporting countries have historically priced oil in dollar terms and accepted mainly dollars for payment. But the relatively strong pace of inflation in recent years in the United States has eroded the value of OPEC's dollar receipts and assets in real terms. A strong case can be made that recent sharp OPEC price hikes represent to a large extent a rational attempt to recapture this lost purchasing power. In a sense, we have been exporting our own inflation to other oil importing countries since the dollar price of oil has been rising just as rapidly to them as it has to us. Note also that most other industrialized countries are far more dependent on imported oil than is the United States. While this situation is certainly bad enough from their point of view, the increased demand for dollars to pay for the ever more expensive oil can also, in the absence of other counteracting factors, serve to place downward pressure on their currencies relative to the dollar and further increase the price of oil in terms of their own currencies. To be certain, there are a variety of monetary and fiscal policies which the governments of these countries can institute - and they have done so frequently in the past - to insulate their economies to some degree from these external shocks. However, from their point of view the necessity of using monetary and fiscal policies in a defense against uncontrollable external forces reduces their ability to use these tools to control domestic economic forces.

And the Responsibility

What can our trade partners do to minimize the effect on their economies of their susceptibility to and dependence on external markets and events? Unfortunately, very little of substance that they are not already doing. Rather, the onus is now more on us. We have been and continue to be this planet's economic giant, and at no time in our history have economic events here been transmitted overseas with as much force as they are being at present. No wonder that when our leaders request cooperative economic assistance from our overseas allies which they perceive to be detrimental to their interests, their initial response tends more often than not to be less than favorable from our point of view. Inflation control, a comprehensive and realistic energy policy, and the return to a moderate but stable and sustainable U.S. growth path remain the best hope for a return to world economic stability. Surely, if the rest of the world catches cold when we sneeze, it should also be true that good health on our part is transmitted abroad in similar proportions.

Dr. Richard S. Smith
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Dr. Richard S. Smith is an assistant vice president and director of International Economics at Northwestern Bank. Prior to joining the bank in October of 1979, he was a senior international economist with Continental Bank in Chicago. He also served as a second vice president and corporate relationship manager in Continental's Multinational Banking Department. Dr. Smith received both his B.B.A. and M.A. degrees from the University of Iowa, and his Ph.D. in Economics from the University of Texas in Austin. While residing in Chicago, Dr. Smith also taught economics at both Roosevelt University and the Keller Graduate School of Management.